CONGRESSIONAL BUDGET OFFICE
ESTIMATE OF COSTS
OF PRIVATE-SECTOR MANDATES

April 22, 1999

Financial Services Modernization Act of 1999

As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on March 4, 1999

SUMMARY

Overall, the bill would reduce existing federal regulation of the financial services industry by relaxing certain restrictions on financial transactions throughout the economy. In particular, the bill would eliminate certain barriers to affiliations among banking organizations and other financial firms, including insurance firms and securities businesses. At the same time the bill would impose restrictions on newly authorized financial activities and prohibit associations between thrifts and commercial entities through new unitary thrift holding companies.

The bill would impose several new private-sector mandates as defined by the Unfunded Mandates Reform Act of 1995 (UMRA). The mandates in the bill would affect the Federal Home Loan Banks, banking organizations, U.S. operations of foreign banks, and insured depository institutions that pay interest on bonds issued by the Financing Corporation. CBO estimates that the net direct costs of mandates in the bill would not exceed the statutory threshold for private-sector mandates ($100 million in 1996 dollars, adjusted annually for inflation) in any one year for the first five years that the mandates are effective.

PRIVATE-SECTOR MANDATES CONTAINED IN BILL

The bill contains several new mandates on businesses in the financial services sector. If enacted, the principal mandates in the bill would:

- Replace the $300 million fixed annual payment for interest on Resolution Funding Corporation (REFCORP) bonds with a 20.75 percent annual assessment on the net earnings of the Federal Home Loan Banks (FHLBs);

- Require banking organizations to adopt several consumer protection measures affecting sales of insurance products;

- End the blanket exemption provided banks from the definition of "broker," and "dealer," making them subject to regulation by the Securities and Exchange Commission;

- Require that foreign banks seek approval from the Federal Reserve before establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices that handle primarily administrative matters, and give the Federal Reserve the authority to examine a U.S. affiliate of a foreign bank with a representative office; and

- Extend the current two-tiered schedule of Financing Corporation (FICO) assessment rates for an additional three years which under current law, would be replaced by a uniform rate for banks and thrifts starting on January 1, 2000.

ESTIMATED DIRECT COST TO THE PRIVATE SECTOR

Most of the cost of the mandates in the bill would result from changes in payments from the Federal Home Loan Banks to REFCORP. CBO estimates the Federal Home Loan Banks would increase their payments to REFCORP by a total of $346 million over the 2000-2004 period as compared with current law. The short-term costs are somewhat misleading, however, because CBO expects that the estimated increase in payments in the near term would be offset by a decrease in payments of an equal amount (on a present-value basis) in future years.

Mandates on banks, banking organizations, and foreign banks would impose some incremental costs of compliance on the industry. The additional costs to these institutions would depend on the actions of regulators and the degree to which new customer protection regulations would preempt state laws. The direct costs of mandates on banks and banking organizations could be at least partially offset by savings from changes the bill would make to expand the powers of banks and bank holding companies. Because of the multiple uncertainties involved and the complex interactions in the financial services sector, CBO

cannot estimate the direct costs, net of savings, with any precision. However, based on discussions with federal banking agencies, securities regulators, and industry trade groups, CBO expects that the costs to banking organizations and domestic operations of foreign banks of complying with mandates in the bill are not likely to exceed the annual threshold established in UMRA.

Insured depository institutions pay interest on FICO bonds based on their deposits in the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF). The increase in costs to institutions that would pay a higher premium on SAIF-assessable deposits (as compared with the expected premium rate under current law) would be completely offset by savings to institutions that would pay a lower premium on BIF-assessable deposits.

Federal Home Loan Bank System

Section 407 would replace the current method of payment made by FHLBs for the interest on REFCORP bonds with a 20.75 percent assessment on the annual net earnings of each FHLB. That is, FHLBs would no longer have to pay a fixed amount regardless of annual earnings; under the bill they would have to pay a fixed percentage of net earnings. Based on projections of net earnings, CBO estimates that the new assessment rate would increase the payments made by FHLBs above the current payment of $300 million annually by $45 million in fiscal year 2000 and a total of $346 million over the 2000-2004 period. However, CBO expects that the present value of the total amount paid by the FHLBs to the federal government would not change. The bill would authorize the Federal Housing Finance Board, which regulates the FHLBs, to extend or shorten the period over which payments are made such that, over time, the average payment would equal $300 million a year, on a present-value basis.

Consumer Protection Regulations—Insurance Sales

Section 202 would direct the federal banking regulators to issue, within one year of enactment, final consumer protection regulations that would govern the sale of insurance by any bank or by any person at or on behalf of a bank. According to the bill, the regulations should include requirements for: (1) anti-coercion rules (prohibiting banks from misleading consumers into believing that an extension of credit is conditional upon the purchase of insurance); (2) oral and written disclosures about whether a product is insured by the Federal Deposit Insurance Corporation (FDIC), about the risk associated with certain products, and about the prohibition against anti-tying and anti-coercion practices; (3) customer acknowledgment of disclosures; (4) an appropriate delineation of the settings and

circumstances under which insurance sales should be physically segregated from bank loan and teller activities; and (5) rules against misleading advertising.

Except for the anti-coercion provision, the provisions in section 202 are based on current industry guidelines issued in 1994 by bank regulators in an Interagency Statement on Retail Sales of Nondeposit Investment Products. The anti-coercion provision is similar to the anti-tying provision in current law. Other new regulations would largely codify a modified version of existing guidelines drafted by the federal banking regulators and, therefore, would not likely impose large incremental costs on banks that currently engage in insurance activities. Moreover, in states where state insurance laws are inconsistent with the prescribed federal regulations but deemed to be at least as protective as those regulations, the new federal insurance customer protection regulations would not apply.

Regulation of Securities Services

The Glass-Steagall Act generally prohibits banks from underwriting and dealing in securities, except for "bank-eligible" securities. Eligible securities are limited to those offered and backed by the federal government and federally-sponsored agencies, and certain state and local government securities. As banks have sought to expand their product lines, federal regulators have provided banks, through affiliated firms, limited authority to underwrite and deal in other types of securities. Generally, a firm that provides securities brokerage services (known as a broker-dealer) must register with and be regulated by the Securities and Exchange Commission (SEC) and at least one self-regulatory organization such as the National Association of Securities Dealers, the New York Stock Exchange, or the American Stock Exchange. Banks, however, are currently exempted from those requirements.

The bill would end the current blanket exemption for banks from being treated as brokers or dealers under the Securities Exchange Act of 1934. Securities activities of banks would, therefore, be subject to SEC regulation, with some exceptions. The bill would exempt from SEC regulation the securities activities of banks handling fewer than 500 transactions annually. Many of the roughly 300 small banks that currently provide brokerage services on bank premises would fall under this exemption. Sections 501 and 502 also would exempt several traditional securities activities of banks from the registration requirements and regulations that apply to brokers or dealers under SEC regulation. The exemptions would cover most products and services that banks currently offer as agents so that they would not trigger SEC regulation. However, for the products and services related to securities that would no longer be exempt under the bill, banks would most likely channel the non-exempt activities through their own securities affiliate or establish a relationship with a broker-dealer. A substantial number of banks that currently handle securities activities have

a broker-dealer affiliate so that the incremental cost of complying with SEC regulation would involve moving non-exempt activities to such an affiliate and would not be significant.

Foreign Banks

Section 152 would amend the International Banking Act of 1978 (IBA) to require that foreign banks seek prior approval from the Federal Reserve Board for establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices. Under current law, a foreign bank must obtain the approval of the Federal Reserve Board (FRB) before establishing a representative office in the United States. A representative office handles administrative matters and some types of sales for the foreign bank owner, but it does not handle deposits. In some cases, foreign banks are establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices and thereby escaping the requirement for approval by the FRB. The bill would strike the exclusion for subsidiaries from the IBA and close this loophole. The industry association estimates that there are fewer than 20 entities that would have to register their subsidiaries as a representative office. CBO expects that the cost to existing subsidiaries of filing with the FRB would be small.

Section 152 also would require that U.S. affiliates of foreign banks with a representative office be subject to examination by the Federal Reserve Board. Under current law, if a foreign bank has only a representative office and no other banking office in the United States, the FRB may examine only the representative office. The FRB cannot examine or seek information from U.S. affiliates of such a foreign bank. The bill would give the FRB the authority to examine a foreign bank affiliate in this situation. CBO has no basis for estimating the potential costs to the industry of such examinations. According to one industry expert, it is likely that the FRB would only use this authority in a case where suspicious behavior warrants further examination. If the FRB would examine affiliates under such limited circumstances, the costs of the mandate to the industry would be very modest.

Three-Year Extension of FICO Assessment Rates

The Deposit Insurance Funds Act of 1996 provided for the payment of interest on bonds issued by the Financing Corporation. Those payments, which amount to approximately $780 million per year, are made by all institutions that are covered by FDIC insurance. Under the act, the FICO obligation was to be split between Bank Insurance Fund (BIF) deposits and Savings Association Insurance Fund (SAIF) deposits such that the rate on SAIF deposits was five times the rate on BIF deposits. Also, under current law, the rates are to be equalized no

later than January 1, 2000. The annual FICO assessment rate is currently about 6.10 basis points for SAIF-assessable deposits and 1.22 basis points for BIF-assessable deposits.

Section 304 would freeze the current FICO contribution formula for 3 years. Without the freeze, on January 1, 2000, both BIF and SAIF members will pay a uniform rate of about 2.2 basis points on insured deposits. Under the bill, for the next 3 years, institutions with SAIF-assessable deposits would have to pay a higher amount than under current law. Institutions with BIF-assessable deposits would pay less than under current law. Some BIF and SAIF members hold assessable deposits in both funds—almost 40 percent of the SAIF-assessable base is held by BIF members and about 2 percent of the BIF-assessable base is held by SAIF members. Since the annual FICO payment would remain constant, the net cost of the freeze to BIF- and SAIF-insured institutions would be zero.

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